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MEXICAN LEGAL NEWS

Constitutional Reform Initiative on Energy Matters

On September 30, 2021, the President of Mexico presented the "*Initiative of Decree amending Articles 25, 27 and 28 of the Political Constitution of the United Mexican States in matters of energy and natural resources*" (the "**Amendment Initiative**") before the Chamber of Deputies, which, if approved under its terms, would represent fundamental changes in Mexico's energy industry.

Specifically, the most relevant aspects of the Amendment Initiative are the following:

Electric Power:

- This is an amendment that implies drastic changes in the industry and a substantial impact on the existing private investment in the sector. By express provision of this amendment, all electricity generation permits granted to individuals to date, as well as the electricity purchase and sale contracts that they have entered, would be cancelled. Likewise, the wholesale electricity market in Mexico would basically disappear and there would be a new regime controlled by the Mexican State through the Federal Electricity Commission ("*Comisión Federal de Electricidad*" or "**CFE**"). Under this new regime, private parties would only be able to provide up to 46% of the energy required by the country, and they would do so under the terms and conditions that the CFE itself would unilaterally determine "*considering total production costs*" and "*guaranteeing the lowest costs for the public service*."

- The Mexican State would retake monopoly control of the national electricity sector through the CFE, which would be the entity in charge of: **(i)** the distribution, transmission, transformation and supply of electric energy, **(ii)** the purchase and sale of electric energy to private generators, **(iii)** the exclusive sale of electric energy to end users, **(iv)** the tariff regulation in distribution, transmission and final cost of electric energy, and **(v)** the control and operation of the National Electric System.

  The Amendment Initiative intends that the Energy Regulatory Commission ("*Comisión Reguladora de Energía*" or "**CRE**") be "suppressed" with the intention that the Energy Secretariat ("*Secretaría de Energía*" or "**SENER**") absorb its functions and structure. Additionally, the National Energy Control Center ("*Centro Nacional de Control de Energía*" or "**CENACE**") would be reincorporated into the CFE's organizational structure.

- With these changes, electric energy and capacity generated by the private sector may only be acquired by the CENACE through the execution of long-term bilateral financial coverage contracts or through contractual mechanisms determined by the CFE under a "special contracting regime" different from those established in Article 134 of the Mexican Constitution, creating an exceptional public procurement regime. The CENACE would acquire such electric energy from the private sector taking into account the competition within such sector and its production costs.

- The figure of "self-supply of electric energy" *(autoabastecimiento)* regulated by the Public Electric Energy Service Law ("*Ley del Servicio Público de Energía Eléctrica*" or "**LSPEE**") will not be recognized anymore; however, those power plants that generate energy and capacity under such scheme in an "authentic" manner (*adjective used in the Amendment, whose application will depend on the interpretation to be adopted*) in compliance with such legal ordinance, may continue generating electricity for sale to the CFE, through the CENACE.

  Along these lines, "independent power producers" that have entered into power and capacity purchase and sale agreements with the CFE under the LSPEE would no longer be recognized as such since such regulatory figure would cease to exist; however, as with the "self-supply" scheme, such power generators could continue to generate electricity to be sold to the CFE through the CENACE. In this sense, it can be interpreted from the Amendment Initiative that **(i)** the power purchase and sale contracts currently entered into between such producers and the CFE would be "cancelled" or terminated in advance, **(ii)** the electricity generated by such producers may be sold to the CFE, through the CENACE in a competition regime within the private sector determined by the cost of energy production as regulated by the CFE, as well as **(iii)** the purchase and sale of surplus electricity from such producer would be eliminated.

  The generation of electric power under the "self-supply" and "independent power producer" schemes would be considered within the maximum limit of 46% participation of the private sector in the generation of electric power.

- The power plants built following the 2013 energy reform would also be considered part of the 46% participation of the private sector in the generation of electricity. However, it is clear from the Amendment Initiative that the electric energy and capacity of such power plants would be acquired exclusively by the CFE through the CENACE, as would be the case with the electric energy generated under the "self-supply" and "independent energy producer" schemes.

  The same would happen with the power plants related to the Long-Term Auctions, in which case the electricity generated by such power plants could be acquired by the CENACE, thereby generating that the coverage contracts currently entered into with CFE Basic Services Supplier and/or with CENACE, in its capacity as clearing house, be terminated in an early manner.

- The "*strict legal separation*" of the CFE would be eliminated in order to reintegrate it as a single State agency, maintaining the subsidiaries *CFE Telecomunicaciones* and *Internet para Todos* and the affiliates *CFEnergía*, *CFE Internacional* and *CFE Capital*, with it being able to create any other subsidiary and/or affiliate it deems necessary.

- By virtue of its control over the operation of the National Electric System, the CFE would be in charge of determining the dispatch of power plants, defining shutdowns, operating conditions, etc., which could translate into the prioritization of the dispatch of CFE's own power plants and, therefore, it would imply putting any electric power generation project developed by the private sector at a disadvantage.

- The "sovereign energy transition" would be exclusively in charge of the Mexican State without the participation of the private sector, with the State being responsible for using <u>all available energy</u>

sources (*regardless of whether they are clean or conventiona*l) to reduce greenhouse gas emissions and components. In this regard, the "clean energy certificates", the only legal instrument that currently exists in Mexico's regulatory framework to incentivize the generation and use of electricity from clean and renewable sources, will be eliminated, which contravenes the Energy Transition Law, the General Law on Climate Change and the Electricity Industry Law, among other domestic provisions and international commitments to mitigate the adverse effects of climate change.

Additionally, "the industries required for the energy transition" would be considered as a priority for national development and therefore the public sector would be exclusively in charge of such industries, understanding as such those related to the entire value and/or supply chain of the electricity industry in Mexico.

Taking into account the limitation of the participation of the private sector in the Mexican electricity industry and the main points of the Amendment Initiative previously mentioned, the Amendment Initiative would imply the imminent elimination of the Wholesale Electricity Market ("*Mercado Eléctrico Mayorista*" or "**MEM**"), thus eliminating, among other things, the sale and purchase of electricity and associated products in such market, as well as the abrogation of the MEM Bases and the MEM Rules. This, together with the fact that the CFE would be the only company that could sell electricity to end users, *de facto* eliminating any free competition market in the electricity sector.

- Finally, the Amendment Initiative establishes that the functions that the State exercises exclusively in electricity would not be considered a monopoly.

Mining:

- The Amendment Initiative incorporates as a national asset, and as such it would become inalienable and imprescriptible, along with other strategic minerals for the Energy Transition, which may not be granted in concession.

- The Amendment Initiative does not describe what should be understood by "minerals considered as strategic for the energy transition"; therefore, it would be the secondary legislation that could describe them or leave such definition as a discretionary power of the Economy Secretariat.

- No new mining concessions would be granted for lithium and other minerals considered as strategic minerals necessary for the sovereign energy transition, in the understanding that those mining concessions already granted by the Mexican State for which gold, silver, copper and other minerals are being explored and/or exploited would be respected. Likewise, mining concessions already granted where there is a history of lithium exploration duly endorsed by the Economy Secretariat will be respected.

- As a result of the foregoing, lithium and other strategic minerals would be incorporated as a strategic area of the State, in accordance with the provisions of the sixth paragraph of Article 27 of the Mexican Constitution, and therefore the State would be exclusively in charge of any activity related to such matters.

- It is foreseen that the functions that the State exercises in a strategic manner over radioactive minerals, lithium and other strategic minerals would not be considered as a "monopoly".

Hydrocarbons:

- The Amendment Initiative eliminates the existence of the National Hydrocarbons Commission ("*Comisión Nacional de Hidrocarburos*" or "**CNH"),** establishing that the powers and structure of this body, as well as those of the CRE, would be absorbed by SENER "as appropriate". However, the initiative does not clarify what is to be understood by "as appropriate", thus creating uncertainty as to the protection of the rights acquired by third parties with which the CNH has entered into contracts as well as the powers that will be exercised by SENER.

- The elimination of the CNH could violate the rights of companies in the upstream market that successfully participated in the bidding rounds for exploration and production fields, since the contracts awarded were entered into with such body. Likewise, it is this body that approves and supervises the exploration and extraction plans under which these companies operate.

- The elimination of the CRE could also be detrimental to the hydrocarbons industry in Mexico, since it would affect the holders and applicants of midstream and downstream permits. This, since the CRE is in charge of issuing and supervising such permits, and its elimination would delay the issuance of permits and the supervisory activities that guarantee the proper functioning of the value and supply chain of the hydrocarbons industry in Mexico.

As it can be seen, the changes implemented by this Amendment Initiative are systemic and fundamental. However, it is uncertain whether it will actually go into effect. In order for this to happen, the Amendment Initiative must be approved by a two-thirds vote of the individuals present in the Chamber of Deputies and the Senate, and also be approved by the majority of the legislatures of the 31 States and Mexico City. Once approved, it must also be promulgated by the executive branch of government and published in the Official Gazette of the Federation.

Notwithstanding the foregoing, the legal strategy of the sectors and companies affected by this Amendment Initiative will have to be analyzed in order to implement a preventive legal strategy against the adverse effects of such amendment, including solutions under Mexican domestic law as well as international law.

If this Amendment Initiative is approved and implemented in its terms, it is foreseeable that numerous foreign companies will consider the option of suing the Mexican State before international arbitration tribunals, demanding the payment of compensation for the damages caused by the violation of their international rights in connection with the promotion and protection of foreign investment.

From a preliminary analysis, if approved as proposed, the Amendment Initiative would affect developers, generators, qualified suppliers, end users under the basic and qualified supply scheme, qualified users, marketers, permit holders and consumer partners of the self-supply/cogeneration scheme, permit holders/contractors (independent production) and in general, participants in the energy industry, including the various sectors of society, the environment and, above all, the national economy and free competition in the energy sector.

Our experts are ready to provide the referred legal consultations. Please do not hesitate to contact us, our contact details are listed below:

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S I N C E R E L Y

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